No. 15457

In the United States Court of Appeals for the Ninth Circuit

Securities and Exchange Commission, appellant

v.

Insurance Securities Incorporated, Trust Fund Sponsored by Insurance Securities Incorporated, Abe P. Leach, Ossian E. Carr, Arthur J. Lonergan, Roy A. Haight, and Leland M. Kaiser as Attorney and Proxy for Investors of Trust Fund, appellees

REPLY BRIEF OF SECURITIES AND EXCHANGE COMMISSION, APPELLANT

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REPLY BRIEF OF SECURITIES AND EXCHANGE COMMISSION, APPELLANT

The Commission's main brief discusses in detail the real issues on this appeal. What we have there said fully answers the basic contentions of appellees and need not be repeated. The purpose of this reply brief is to correct certain major misconceptions which appear in appellees' brief and are sufficiently important to require re-emphasis.

1. Appellees incorrectly phrase the principal issue to be whether the Act purports to "regulate the sale by any stockholder of his stock in a service company or limit the price" (Br., p. 20). Having thus characterized the transaction in this case, appellees then argue at length that such sale does not, and cannot,

violate any fiduciary obligations of ISI and its directors and officers with respect to the Trust Fund under Section 36, since nowhere in the statute is there any express or implied provision regulating transactions in the stock of a service company (Br., pp. 30 ff., 47–49).

Such an approach, we submit, focuses attention merely upon the ostensible form of the transaction rather than upon essential realities. Since ISI performs fiduciary services for the Trust Fund and its directors and officers are likewise fiduciaries with respect to the Trust Fund, the real question is whether, in the guise of selling stock control, these fiduciary relationships have been exploited by the ISI directors and officers for their own benefit. Therefore, to observe that the Act does not purport to regulate the sale of stock in a "service company", as that term is used by appellees, does not dispose of our complaint. The established principles of equity forbid a fiduciary to capitalize on the fiduciary relationships, which is what we allege has occurred here as an intended consequence of the sale of stock. The Act conclusively establishes that advisory and principal underwriting contracts create fiduciary relationships, and Section 36 of the Act gives the Commission standing to enforce by court action the performance of fiduciary duties in this area.

In the instant case, the complaint specifically alleges that \$50 per share for the ISI stock did "not represent the real and actual value" of the ISI shares; that it "reflected the value of the perquisites and emoluments" which ISI derives from its agreements with

the Trust Fund; and that such agreements, being non-assignable, are not disposable assets of ISI (R. 9–10). We have no doubt that, as alleged in the complaint, the seller obtained, and the buyers paid, $50 per share for the ISI stock, or over twenty-five times its net asset value, as the price for the strategic position of ISI and its directors and officers to dictate or influence the course of the succession to the underwriting and advisory relationship with respect to the Trust Fund. As thus understood, the transaction in this case can hardly be likened, as appellees suggest, to a sale by ISI of "its typewriters, its tables, or its sales organization to third parties" (Br. p. 49). See also pp. 45–48 of our main brief. Nor is this a case, as appellees suggest (Br., pp. 55, 59–61), which involves regulation or control over fees of ISI under existing contracts between ISI and the Trust Fund. This is a case in which appellee directors and officers have in effect sold the advisory and underwriting contracts for personal profit in violence to settled equitable principles. The sale of stock was merely the means by which this was accomplished.

2. Appellees argue that Section 36 of the Act should be narrowly construed and limited to cases of "self-dealing", namely, transactions between the investment company and the service corporation, directors, officers and others in similar positions (Br., p. 49 ff.). In support of their view, appellees quote extracts from the House and Senate Reports and from the testimony of Commissioner Healey (Br., pp. 49–51). These ~~con-~~ Ex- tracts do not in terms deal with Section 36. They deal with the general problem of "self-dealing" between

the investment company and those who manage it. Undoubtedly, this was one of the major abuses which the Act was designed to remedy. Certain transactions between the investment company, its investment adviser, directors, officers, and other affiliated persons are now subject to Commission review and examination under Section 17 of the Act. It is rather curious that later on in their brief (p. 88) appellees state that cases of "self-dealing" which come under the ban of Section 17 "do not fall under Section 36." But there is nothing to indicate that Section 17 was intended to narrow the scope of Section 36.

Indeed, in enacting Section 36, the Congress intended that investment advisers, principal underwriters, directors, officers and others therein specified be held to fiduciary standards, and that the Commission have the standing and duty to enforce these standards in the civil courts. The reasons set forth in our main brief, pp. 26–31, 37–55, and the cases discussed at pp. 56–67, clearly indicate that the limitations which appellees seek to impose upon Section 36 are not supported by the text, its legislative history and the historic fiduciary principles enforced by courts of equity. In fact, when in an earlier draft "gross misconduct or gross abuse of trust" was declared "unlawful", the objection was made that under this broad standard a person would be subject to criminal penalties. When in the final draft, Section 36 was limited to a civil remedy for an injunction, the breadth and scope of the fiduciary standards and obligations encompassed within the terms "gross misconduct or gross abuse of trust" were not altered in any way. See our main brief, pp. 84–89.

In terms of the instant case, the trafficking in management contracts is a breach of fiduciary duty and therefore, on the facts, a gross abuse of trust. There is nothing to support the contention that "gross abuse of trust" in Section 36 does not extend to its full meaning in settled principles of equity. On the contrary, the legislative history reinforces the plain meaning of the section that the Commission may, through this type of civil action, enforce any aspect of fiduciary duty. And Congress was expressly concerned with the prevention of the trafficking in management contracts.

3. Appellees further argue (Br., pp. 37–48) that fiduciary standards under Section 36 are not applicable because the Congress provided a specific remedy. They refer to Section 1 (b) (6) which recites the evils resulting "when investment companies are reorganized, become inactive or change the character of their business, or when the control of management thereof is transferred, without the consent of their security holders." On the basis of this recital, appellees contend that to avoid the grave abuse resulting from the sale or transfer of management contracts (which we have detailed in our main brief, pp. 31–37), the Congress deemed it sufficient to provide in Section 15 that on sale or transfer of stock control the investment advisory and principal underwriting contracts are terminated and left it for investors to decide by vote whether or not to enter into new arrangements with the investment adviser or principal underwriter under different control. This argument fails to note that stockholder approval is neces-

sary for an attempted transfer where *no* unlawful consideration is involved. It is therefore unsound to reason that Congress intended stockholder approval to be sufficient to validate an attempted transfer where there *is* an unlawful consideration. However, we have discussed this contention at great length in our main brief (pp. 68–88), and no useful purpose would be served by repeating our arguments here.

4. Appellees argue by way of analogy (Br., pp. 57–58, 63–64), that stock of corporate fiduciaries, such as banks with trust departments, is freely sold in the market, and that there is no legal limitation on the price of the stock by reason of any value attributable to its earnings from its trust services.

Appellees cite no cases, and it may be that under some circumstances a sale of stock control of banks at a premium would involve a breach of trust. However, it is not necessary to resolve the laws relating to banks to resolve the instant case. Banks, both state and federal, have experienced a long history of special legal treatment both by courts and legislatures, and provide a body of law largely distinct from that relating to investment companies. With respect to the latter, the enforcement of fiduciary standards under Section 36, as we urge here, is clearly essential as a necessary corrective against past abuses and as an implementation of Congressional policy against trafficking in management contracts. Indeed, as noted in our main brief, pp. 34–35, purchase of stock control in the service company at a premium was one of the typical devices for trading in these fiduciary arrangements. If no such correctives are necessary with respect to banks,

it may be that past experience does not require it and regulation of banks under federal or state law may provide adequate safeguards. The Congress did not regard the two situations comparable. Section 3 (c) (3) expressly excludes from the definition of "investment company" and, hence, beyond the regulatory reach of the Act, "any bank or insurance company" and "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian . . . ."

5. Although about 53% of the ISI stock was sold to the purchasers, of which about 40% represented stock owned by the four directors and officers of ISI, appellees argue that there was no sale of stock control (Br., pp. 94–97). Under Section 2 (a) (9), they state, presumptive control requires more than 25% of the voting stock, whereas in the present case no one person owned, sold or purchased as much as 25% of the ISI stock.

Section 2 (a) (9) makes clear that stock control is not necessarily based upon ownership of more than 25% of the voting stock. Such ownership creates a presumption of control. Less than 25% presumptively negatives control, but such presumption is rebuttable by evidence in the manner therein provided.[1] The

[1] Appellees' misconception that 25% of voting stock is the test of control underlies the "curious" distinctions as to the applicability of Section 36 (Br., p. 10). Appellees erroneously attribute these distinctions to the Commission and then label them as "fantastic" (Br., p. 11).

Commission's complaint specifically alleges that the sales of the ISI shares between February and July 1956—well over 25%—were effected pursuant to a plan (R. 8-9). See our main brief, pp. 88–89. We submit that the Commission is therefore entitled to the benefit of the statutory presumption in ruling on the present motion.

Appellees deny the existence of such plan or concert of action (Br., p. 97–104). They rely upon the affidavits of the buyers and sellers which include self-serving denials that there was a plan (R. 63, 69, 72, 74, 82, 84, 86, 87). It is these denials that appellees regard as sufficient to show the Commission's allegations to be a "sham" (Br., p. 97). They also assert that we "submitted no affidavits or showing tending to the contrary" (Br., pp. 97–98). This assertion ignores our affidavits (R. 106–112, 130–131), which are summarized in our main brief, pp. 7–10. They are based upon documentary proof and are not, and cannot be, denied by appellees.[2] See also our main brief, pp. 89–91.

At most appellees' denials tender issues of fact which the court below said are not reachable on a motion to dismiss or for summary judgment (R. 160), and decided the case on the assumption that, as alleged in the complaint, a transfer of stock control of ISI occurred (R. 146–147). In their discussion of the cases cited in our main brief, pp. 90–91, appellees ignore the pertinent ruling of this Court in *Lane Bryant, Inc.* v.

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[2] Appellees hardly discuss the contents and thrust of our affidavits and label them as "irrelevant" (Br., p. 101). We are content to let the affidavits speak for themselves.

Maternity Lane, Ltd., 173 F. 2d 559, 565. The observations of the Third Circuit in *Toebelman* v. *Missouri-Kansas Pipe Line Co.,* 130 F. 2d 1016, 1022, are disposed of by a statement that that court "is notoriously out-of-step on the subject of summary judgment" (Br., p. 98, fn. 5).

6. Appellees contend that even if the transaction in this case constituted "gross misconduct or gross abuse of trust", ISI and its directors and officers are not persons within the reach of Section 36 (Br., pp. 73–81, 86–93). We have dealt with this contention in our main brief, pp. 91–103.

Appellees' contention that, even if an injunction may issue in this case, the court has no power to require an accounting for the pecuniary benefits derived by the individual defendants from their wrongful conduct (Br., pp. 81–84), is inconsistent with *Aldred Investment Co.* v. *SEC.,* 151 F. 2d 254, 261 (C. A. 1, 1945), *certiorari denied,* 326 U. S. 795 (1946). In that case, which arose under Section 36, the court said: "Section 36 invokes the equity power of the Federal court and that calls into play its inherent power where it is necessary to do justice and grant full relief." In that case, the court issued the injunction provided in Section 36 and in addition upheld the power of the district court to appoint a receiver for the investment company. In a subsequent appeal the court held that the district court had power to direct liquidation or reorganization of the investment company where such a course appeared in the best interest of investors, *Bailey* v. *Proctor,* 160 F. 2d 78, 81–83 (C. A. 1, 1947), *certiorari denied,* 331

U. S. 834 (1947). An accounting for the profits to the Trust Fund, which is a party to these proceedings, is merely incidental to the statutory relief expressly prescribed by Section 36. The power of the district court, as a court of equity, in this respect is beyond dispute. See *Porter* v. *Warner Holding Company,* 328 U. S. 395 (1946).

7. Appellees argue that count two of the complaint alleging violation of the Commission's Proxy Rules is now moot since the meeting of investors has been held and the proxies have been voted (Br. 105–106). They ignore the fact that the Commission brought this action before the meeting of investors and sought a preliminary injunction to restrain the voting of the proxies on the proposed investment advisory and principal underwriting contracts (R. 14–15). At the meeting of investors held on August 15, 1956, the proxies were not voted on these proposed contracts and other matters under the Interlocutory Order of the court, dated August 14, 1956, (R. 48–49), and the meeting was adjourned. Under the Second Interlocutory Order, filed August 30, 1957, the Commission withdrew its motion for a preliminary injunction upon the express condition, *inter alia,* that this was without prejudice to appropriate relief with respect to the investment advisory and principal underwriting contracts if it is determined in a final decree that the Commission was entitled to judgment. If, as we urge, the proxies have been unlawfully solicited and the existing contracts between ISI and the Trust Fund have been terminated because of the sale of stock control of ISI, ISI has been acting as invest-

ment adviser and principal underwriter in violation of Section 15 (See pp. 39–42 of our main brief). Appropriate relief against this violation is clearly in order.

Appellees' contention that ISI's proxy solicitation material was not false and misleading and that there were no material omissions of fact (Br., pp. 106–114) are fully discussed in our main brief, pp. 103–111.[3]

CONCLUSION

The relief as set forth in our main brief, pp. 111–112, should be granted.

Respectfully submitted.

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[3] One of the Commission's contentions is that since the sale of stock control involved a breach of trust under Section 36, the proxy material was false and misleading in having characterized the consequence of the sale as "technical", namely, the termination of the contracts under Section 15. Appellees state (Br., p. 109) that this is an afterthought, and that it did not appear in the original or amended complaint. They ignore paragraph 30 of the Commission's complaint (R. 12–13).

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